CHAPTER IV

RECENT POLICY ACTIONS AND ALTERNATIVES FOR THE FUTURE

Possible ways to improve the Stafford Loan program have become a focus of discussion as a result of concerns about the direction of federal student loan programs and the opportunity to reevaluate student aid policies provided by the pending reauthorization of the Higher Education Act.

RECENT LEGISLATIVE CHANGES

The Omnibus Budget Reconciliation Act of 1990 made several changes in the budgetary context and operation of the guaranteed student loan programs. These modifications will affect the ease with which future legislative changes can be made.

Changes in Budgetary Rules and Procedures

The Budget Enforcement Act, a part of the Reconciliation Act of 1990, sets new rules for federal spending through 1995 that could have a major impact on future changes in the Stafford Loan program.[1] Legislative expansions in entitlements, such as the Stafford Loan program, are potentially limited by features of the new law that are termed "pay-as-you-go." Specifically, one entitlement program can be expanded only if others are cut or if taxes or fees are increased. In addition, the trade-off between spending in entitlement programs and spending in discretionary programs has been eliminated since domestic discretionary programs have a separate spending cap set forth in the new budget law. Generally, increases in spending on entitlements cannot be offset by reductions in spending for discretionary programs and vice versa. This feature is particularly relevant for higher education programs because Stafford Loans are an entitlement and Pell Grants are discretionary spending.

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1. For a thorough discussion of the new budget process, see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1992-1996* (January 1991), Chapter II.

The Budget Enforcement Act also changes the way that federal credit programs are reflected in the budget (see Box 2). Federal loan guarantees, such as those of the Stafford Loan program, were previously included in the budget on a cash-flow basis. Henceforth, the government's long-run cost, or subsidy, for a loan guarantee will be recorded as a budget outlay when the loan is disbursed. This change in accounting, which is part of broader changes together termed credit reform, places loan guarantees and other federal spending on an equal footing.

Modifications in the GSL Programs

Legislative changes in the GSL programs under the Reconciliation Act included eliminating schools with high cohort default rates from the GSL programs, delaying the disbursement of loans to all first-time, full-year undergraduate borrowers, and requiring the independent testing of federal student aid recipients without high school diplomas or General Education Development diplomas. The Emergency Unemployment Compensation Act of 1991 added wage garnishment as a tool that can be used in all states for collecting defaulted loans.

Eliminating Schools With High Default Rates. Federal law now requires that schools with very high cohort default rates be excluded from participating in the GSL programs. Specifically, in 1992, students at schools with cohort default rates of 35 percent or more in each of the three previous years will be unable to receive GSLs. Beginning in 1993, schools with cohort default rates of 30 percent or more in each of the previous three years will be ineligible for the program. Historically black colleges and universities and tribally controlled community colleges are exempt from the requirements until July 1994.

Delaying Disbursement of Loans. GSLs cannot now be disbursed to new borrowers until 30 days after classes begin. In 1990, this provision applied only to borrowers attending schools with high cohort default rates. As a result, loans will not be disbursed to early dropouts--borrowers who have been found to be especially likely to default.

Requiring Independent Tests of Certain Applicants. Federal law now requires that applicants without high school or GED diplomas pass a test designed to measure their likelihood of success in acquiring further education. The test must be administered by an agency that is independent of the schools that the students plan to attend. Previously, the schools themselves determined whether the applicants would benefit from the education, leading to charges that some schools admitted students who had little prospect of success.

BOX 2
The Budgetary Impact of Credit Reform on the Stafford Loan Program

Federal loan guarantees were previously included in the budget on a cash-flow basis; that is, federal payments in support of the guarantees were included as outlays in the years in which they occurred. Using this method of accounting, the costs of the Stafford Loan program for the anticipated $8.7 billion in new loan guarantees for 1992 would have been recorded as an estimated $30 million in 1992, nearly $700 million in 1993, and over $1.2 billion in 1994, reflecting estimates of the pattern of interest and default payments on these loans (see below). Payments on the loans originating in 1992 would total about $2.95 billion.

Under credit reform, the government's expected long-run cost, or subsidy, is recorded when the loan is disbursed rather than when the payments actually occur. Based on previous experience and expected patterns of behavior, the subsidy rate for the Stafford Loan program is estimated to be 28 percent. That is, the federal government is expected to spend 28 cents for each dollar in loans it guarantees (11 cents for interest payments while students attend school, 10 cents for net default payments, 6 cents for interest copayments after borrowers leave school, and 1 cent for other costs). This subsidy rate leads to recorded costs of $2.45 billion--28 percent of the $8.7 billion borrowed. This amount, together with the interest it will earn, will be enough to make the estimated $2.95 billion in payments expected to be required in 1992 and future years.

BOX TABLE PROGRAM OBLIGATIONS AND OUTLAYS UNDER CASH FLOW ACCOUNTING AND CREDIT REFORM IN THE STAFFORD LOAN PROGRAM (In millions of dollars)

	1992	1993	1994	1995	1996 and Beyond	Total
Cash Flow Accounting						
Program Obligation	92	801	1,184	445	428	2,950
Outlays	30	691	1,254	490	485	2,950
Credit Reform						
Program Obligation	2,453	0	0	0	0	2,453
Outlays	1,695	758	0	0	0	2,453

Wage Garnishment. Recently enacted federal law now allows up to 10 percent of the earnings of any borrower who is in default to be garnished. In states with cumbersome garnishment procedures, this will facilitate the collection of defaults.

THE NEED FOR FURTHER CHANGE

In light of the concerns about the financial stability and overall integrity of the GSL programs, and given recent modifications in these programs, what further changes, if any, should be made in the Stafford Loan program?

The Case Against Change

A case against further modification can be made both on the basis of program outcomes and costs. Millions of students have borrowed through the Stafford Loan program, helping them to attend postsecondary schools. In addition, annual default rates and current costs are in line with what many would expect for a program that lends to large numbers of students. At about 7 percent a year, the annual default rate in the GSL programs is not unlike the annual default rates in some other federal loan programs. Lending to people with no collateral and little credit history entails risk. For example, one would expect default rates to be higher for student loans than for secured mortgages. Without the government guarantees, however, many students would be unable to finance their educations.

Defenders of the current program also argue that sizable costs should be expected in a program that provides substantial interest subsidies to large numbers of borrowers. It is primarily the growth in borrowers, rather than an increase in the default rate, that has fueled the growth in costs.

The Case for Change

Even if the arguments against further change are persuasive, the federal government might still require guaranty agencies and banks to provide more information about applicants and recipients, so that the impact and desirability of future changes in policy could be better assessed. Specifically, banks and guaranty agencies could be required to provide information on the financial condition and dependency status of each applicant and on the size of loans and the amount of the borrower's indebtedness. This information would make gauging the direction of the program easier and more accurate. For example, one could then determine the extent to which low-income

families depend on loans to finance postsecondary educations. Information on changes in the patterns of borrowers would also be available more quickly, allowing policy to be more responsive to any problems that might arise.

It can also be argued that further changes should be made in the Stafford Loan program. Some critics charge that its costs have grown too rapidly and that its default rates are excessive. At over $3.7 billion per year, its cost represents a sizable allocation of federal resources. Given the present budgetary tightness, some people argue that this form of relatively untargeted federal spending should be curtailed. They believe that federal funds should be used more to assist those in greatest need--through the Pell Grant program, for example, or through other highly targeted federal aid programs.

While recent legislation has attacked the symptom of high default rates, it probably has not affected their underlying causes. High default rates may indicate a lack of integrity in the program. Students borrowing to attend schools that provide little education are worse off than if they had not attended school because they have loans to repay while receiving little in return.

Other observers worry that because the maximum loan has not kept pace with the rapidly rising costs of postsecondary education, the ability of many students to attend postsecondary schools or to choose to attend higher-priced ones has been limited.

A number of broad proposals have been made that would change the mix of federal aid between grants and loans or would fundamentally restructure the GSL programs. While these options are beyond the scope of the paper, the remainder of this section briefly outlines them. The next sections consider the incremental options that are the focus of this study.

Some proponents of changing the mix of federal aid would target grants more toward the poorest students. This outcome could be achieved either by only raising the level of grants provided to these students or by raising them in combination with lowering the grants provided to higher-income students. Other advocates of changing the mix of aid would modify the rules for federal grant and loan programs so that students in their first two years of postsecondary school would be eligible for larger federal grants. Students in their third year and beyond would no longer be eligible for federal grants but could potentially borrow more than they can now.

Other proposals would restructure the GSL programs. One approach would be to centralize them. Under this plan the federal government would administer the program and pursue collections on defaulted loans. Guaranty

agencies would no longer be needed. Otherwise, the structure of the program would not change, so that students and lenders would notice little difference.

Another approach would be to create a direct loan program, whereby postsecondary schools would dispense federal loans. Under this option, schools would act as administrative offices with the federal government supplying the capital. Banks would no longer be involved with student loans. Before the recently enacted credit reform a direct loan program would have been prohibitively expensive because all the lending would have been counted as a federal expense when the loans were disbursed. With credit reform, only the subsidy value of the loans is recorded as a cost to the federal government, making the reorganization possible.

A third approach to restructuring the GSL programs would tie loan repayments to the incomes of borrowers after they leave school. The federal government would lend directly to students and the Internal Revenue Service would collect loan repayments. The annual repayments would vary with the size of the loans and with the incomes of the borrowers.

IMPROVING THE OUTCOMES FOR STUDENTS

This section explores a number of specific alternatives in the Stafford Loan program that have been suggested as better serving the needs of students. They include increasing the maximum loan, requiring independent counseling for prospective borrowers, tightening accreditation standards, and requiring schools to share in the costs of their defaults.

Increasing the Maximum Loan

As discussed in Chapter I, the maximum Stafford Loan has not kept pace with the rising costs of postsecondary education. In particular, the maximum loan for first- and second-year undergraduates has fallen to 60 percent of the average cost of a public education and 20 percent of the average cost of a private education, and the maximum loan for more advanced undergraduates now pays for 90 percent of the average public cost and 30 percent of the average private cost. In contrast, it used to pay for more than 100 percent of the average public cost and 80 percent of the average private cost for all undergraduates. To remedy this decline, some analysts suggest increasing the maximum loan for undergraduates to reflect the rising costs of education.

Raising the limits to $4,500 for all undergraduates (from $2,625 for first- and second-year undergraduates and $4,000 for other undergraduates)

would allow them to borrow enough to finance the current average cost of education at a public four-year college. The change would raise federal outlays by $255 million in 1992 and by $2.2 billion over the 1992-1996 period.

Proponents of this option argue that allowing students to borrow more would encourage some potential students to enter postsecondary schools and would allow others to attend more expensive schools, benefiting themselves and the economy if they found better jobs. In addition, for current borrowers who do not choose to attend more expensive schools, raising the maximum loan would help ease their difficulties in paying for school. As a result, some might reduce the number of hours that they were employed, allowing them more time for their studies.

Opponents of raising the maximum loan contend that many students already have too much debt when they leave school, particularly those who do not graduate from a four-year college. Further, increasing the maximum loan might encourage some schools to raise their tuitions to capture additional federal funds available, thus adversely affecting all their students rather than giving students receiving Stafford Loans more flexibility in financing their education. Schools whose students now receive substantial amounts of federal and state aid might be particularly successful at raising tuitions because higher costs would allow their students to receive more aid. Finally, some think that if there were to be additional spending on postsecondary education, it should be targeted on those with the greatest need--through the Pell Grant program or through reductions in the expected family contribution of low-income families--rather than given to the relatively better-off students who borrow through the Stafford Loan program.

Requiring Independent Counseling of Prospective Borrowers

Another option to improve the outcomes for students is to require independent counseling for prospective borrowers or for borrowers wanting to attend schools that have high default rates. It appears that some schools encourage students to borrow by overstating the prospective economic benefits of the programs they offer. When the borrowers are unable to find the jobs they expected, some of them default on their loans. As discussed in Chapter III, those who do not complete their programs as well as those with lower incomes--both potential indications of little benefit from schooling--are more likely to default than is the average borrower. Many of the prospective students who do not benefit greatly from their postsecondary educations may be unaware of, or have little access to, counseling services that could help them to choose their best options. Counseling centers could be funded from several sources--the federal government, the students when they met with

counselors, or proceeds from borrowers' loans (in which case the charge would need to be sufficiently large to cover the costs of students who chose not to borrow).

Requiring prospective borrowers to obtain counseling from independent centers established and run by the federal government or by the guaranty agencies could provide them with a better understanding of their choices and help them to select institutions and programs that are well suited to their talents and goals. The counselors could inform prospective students of the graduation rates and future job opportunities of the students currently attending different schools, for instance, and provide other information relevant to the future success of the borrowers. As a result, the "match" between students and schools might be improved.

Requiring the use of independent counseling services would add to the bureaucracy of applying for Stafford Loans, however. This time-consuming process would not be of much value to students already receiving good advice about postsecondary education. In fact, if some schools could unduly influence the counselors, the "independent" services might work poorly, encouraging students to pursue educations unsuited to their abilities or goals. In such cases, some students could make poorer choices than they would have made without counseling.

Strengthening the Accreditation Procedure for Schools

To be eligible to participate in the GSL programs, schools must be licensed and accredited. Generally, states award licenses and the U.S. Department of Education recognizes accrediting agencies that determine whether schools provide quality educations. Serious questions about the integrity of the program have been raised, for example, in testimony at recent Congressional hearings that charged that both becoming an accrediting agency and becoming accredited are too easy.[2] The Department of Education conducts few independent audits, leading to schools being accredited that would not be if the Department were more careful.[3] Some observers also argue that the current system appears to give schools a false "seal of approval" from the federal government.

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2. U.S. Senate, Permanent Subcommittee on Investigations, *Abuses in Federal Student Aid Programs*, Report 102-58 (May 17, 1991).

3. Department of Education, Office of Inspector General, Semiannual Report to Congress (April 1-September 30, 1990).

In response to questions of program integrity, minimum standards to be used by independent agencies in accrediting postsecondary institutions have been suggested. For example, the Department of Education has proposed using indicators of school quality such as retention rates, success rates on licensing examinations, or job-placement rates in assessing whether or not schools should be accredited. Different standards might be used for different types of schools. For example, graduation standards might be less stringent at two-year than at four-year schools because many students attending community colleges do not intend to receive degrees. Alternatively, it takes less time to receive a community college degree, suggesting an adjustment in the opposite direction.

In contrast, some opponents of strengthening accreditation practices counter that the Stafford Loan program needs enforcement of current rules, not additional regulation. Others contend that the primary responsibility of accrediting agencies is to ensure quality educations, not to reduce loan defaults. In fact, although accreditation standards also vary greatly among accrediting agencies, and average default rates on student loans differ among schools accredited by different agencies, it is unclear whether the schools approved by agencies with tougher standards have lower default rates. Finally, stronger accreditation standards would create more work for all schools, not just those with low standards. In particular, many colleges and universities argue that their academic standards are high and that additional government interference might impinge on their academic freedom.

Requiring Postsecondary Institutions to Pay a Loan Default Fee

Incentives in the Stafford Loan program could also be modified to encourage institutions to provide better educations. Under current law, schools do not pay any of the costs of the defaults of their former students, providing at least some schools with a financial incentive to fill their classes without offering quality educations. Charging postsecondary institutions an annual fee related to their cohort default rates would reduce the incentive of schools to encourage students to borrow who are unlikely to gain from the programs. These borrowers, many of whom do not complete programs or have low incomes after leaving school, are more likely to default than the average borrower, as seen in Chapter III.

This approach would increase the motivation of institutions to ensure that their students repaid their loans. It might induce schools both to emphasize to students their obligation to repay loans and to state more honestly the economic benefits that students could expect to derive from the education. Many specific plans to do this could be enacted. For example,

schools with cohort default rates greater than 10 percent could be required to pay a fee of 25 percent of the value of the defaults of their former students in excess of the first 10 percent of defaults. Enacting this option would provide an estimated $155 million in payments to the federal government in 1992 and $890 million over the 1992-1996 period.

Postsecondary institutions might, however, pass these costs on to students through higher charges rather than improving the quality of their programs. Enacting this option could also create financial stress for institutions with high cohort default rates that are unable to raise tuitions, even though some of them may be offering high-quality programs to disadvantaged groups. Finally, some students from low-income families--who, as discussed earlier, are more likely to default--might be denied admission or denied access to a loan by a school's financial aid officers for fear that they would increase the school's cohort default rate. This outcome would be counter to the goal of increasing access to postsecondary education.

REDUCING FEDERAL COSTS

Although the Reconciliation Act of 1990 modified the GSL programs in ways that will lower federal costs, additional changes to further reduce the allowable cohort default rate, or to cut subsidies to students, lenders, and guaranty agencies, could reduce federal spending on the Stafford Loan program and improve its efficiency. Some of the approaches examined here could reduce the usefulness of the program, however, if they made it more difficult for students to pursue their educations. To protect against this, funds that derive from these options could be used at least in part to expand other federal spending on postsecondary education, such as broadening the availability of Stafford Loans or increasing the maximum loan.

Further Restricting Allowable Cohort Default Rates at Schools

Some analysts propose further restricting the allowable cohort default rates of schools participating in the Stafford Loan program. As discussed earlier, in 1990 the federal government eliminated most schools with cohort default rates above 35 percent during each of three consecutive years. This cutoff will become somewhat more stringent, 30 percent, beginning in 1993.

One approach to tightening these standards further would be to define the default threshold as only the previous year's cohort default rate, as is done in the Supplemental Loans for Students program, rather than using the cohort default rates from the previous three years. Doing so would save an

estimated $185 million in 1992. A second approach would be to decrease the threshold--to 20 percent, for example--without changing its calculation. This option would save an estimated $250 million in 1992. Combining these options would save about $385 million in 1992. The savings over the 1992-1996 period would be considerably greater--$885 million, $1.1 billion, and $1.8 billion, respectively. (These estimates are contingent on preventing operators of disqualified schools from regaining eligibility by a name change or similar device. If such a prohibition were weak, savings from this option would be reduced significantly.)

Proponents of these approaches argue that the current restrictions still allow schools with excessive default rates to remain in the program, leading to higher federal costs and poor educations for their students. Opponents argue that schools with high cohort default rates are often those that serve a disproportionate number of low-income students--students who are more likely to default, even when the program is of high quality--and that the cohort default rate is a poor measure of which schools are providing inferior programs. They suggest that eliminating these schools would unfairly penalize some that offer useful programs. As a result, some needy students would have less access to postsecondary education from which they might benefit.

Reducing the Subsidies to Students, Lenders, and Guaranty Agencies

Students, lenders, and guaranty agencies all receive considerable subsidies in the Stafford Loan program. Requiring borrowers to pay a larger portion of the interest costs, reducing interest payments to lenders, and eliminating the administrative cost allowance to guaranty agencies would all reduce the subsidies and hence federal costs.

Increasing Interest Costs Paid by Borrowers. Requiring borrowers to pay a higher portion of the interest costs of their Stafford Loans than they do now could be accomplished in several ways. New borrowers could be charged interest on their loans while they attend school, for example, with payments beginning after they leave school. This approach would be similar to the interest assessments in the Supplemental Loans for Students and PLUS programs. Alternatively, or in addition, the interest rates charged to new borrowers could be raised after these borrowers leave school. A variation of this approach would also require new borrowers to begin accruing interest on their loans immediately after leaving school rather than after six months, as under current law, but would allow a grace period of six months before the first payment was due.

If enacted, charging borrowers a fixed interest rate of 8 percent while they attend school (and simultaneously eliminating the origination fee) would reduce federal outlays by an estimated $575 million in 1992 and $4.1 billion over the 1992-1996 period. Charging new borrowers the full interest cost on new loans after they leave school would save an estimated $325 million in 1992 and $2.1 billion in the 1992-1996 period if borrowers were charged interest during the grace period, and $105 million in 1992 and $725 million during the 1992-1996 period if they were not.

These measures would not cause cash-flow problems for borrowers while they attended school because they would be allowed to defer interest payments during that period. With the added costs generally occurring only after leaving school--when borrowers would be better able to afford them--most students would still be able to continue their educations. In addition, because graduate students and four-year college graduates now receive the largest interest subsidies, as discussed in Chapter III, this change would make the payments on behalf of students more even. The larger repayments that would result from these changes might, however, cause some students to forgo school or to limit their choices to lower-priced institutions, thus in part defeating the goals of access and choice.

Reducing Subsidies to Lenders. The federal government guarantees lenders a rate of return on Stafford Loans that is 3.25 percentage points above the 91-day Treasury bill rate. As discussed in Chapter II, this is much greater than their average costs. Reducing the guaranteed yield to 1.5 percentage points over the 91-day Treasury bill rate while students are in school and in the grace period (when lenders' servicing costs are about 0.5 percentage points), while simultaneously cutting the lenders' interest rate to 2.25 percentage points over the Treasury bill rate after students leave school, including any time they have a deferment (when lenders' servicing costs average about 1.25 percentage points), would decrease federal outlays by $290 million in 1992 and $1.7 billion over the 1992-1996 period.

Alternatively, banks could bid for the right to make Stafford Loans. One option would be for banks to bid to lend specific dollar amounts at a particular interest rate above the 91-day Treasury bill rate. This rate could be allowed to vary with the type of school that the borrowers attend. The savings would depend on the interest rates that the banks agreed to receive.

Reducing the interest rate paid to lenders would lower federal expenditures without increasing students' costs. Moreover, this change might lead to little negative response by lenders because most of them would still make profits. During 1989, the 100 largest lenders--making up fewer than 1 percent of all lenders--disbursed about 75 percent of all loans. If the banks

bid on the right to lend, profits could be reduced to the minimum level acceptable to them.

These options might, however, make lending to students from certain schools unprofitable for all the lenders in a geographic region, causing some students to have more difficulty financing their education unless they attended other schools.[4] In particular, requiring banks to bid for the right to lend might concentrate the program even more in a few large banks, making it more difficult for students in other areas to borrow. In fact, it might lead Sallie Mae to become an even more dominant force in the secondary market.

Eliminating the Administrative Cost Allowance. Each year, the federal government pays the guaranty agencies an administrative cost allowance equal to 1 percent of the value of new loans they guarantee. Eliminating this allowance would save the federal government an estimated $80 million in 1992 and $535 million over the 1992-1996 period.

Proponents of this change argue that many guaranty agencies have larger reserves than are necessary to protect them from their expected defaults, indicating that the federal government provides excessively generous terms for the agencies. Eliminating this source of revenue would also encourage many agencies to further minimize their costs.

Some opponents of this option contend that some guaranty agencies are already financially unsound, and that reducing their revenues could push them into insolvency. Other critics, using a different line of reasoning, believe that many guaranty agencies would respond to any reduction in revenue from the federal government by raising the insurance premiums, perhaps up to the limit of 3 percent of the face value of the loans, thus raising the cost of the program to borrowers.

4. Although there is a provision in the law whereby guaranty agencies must act as lenders if students cannot find a bank to lend to them, this provision has not been widely used to date.

APPENDIX A

THE CALCULATION OF AND THE RELATIONSHIPS BETWEEN DEFAULT RATES

This appendix provides a numerical example showing the relationships between the cumulative default rate, the annual default rate, and the cohort default rate used in the guaranteed student loan programs. These default rates are defined as follows:

Annual default rate =

$$\frac{\text{value of new defaults in a given year}}{\text{value of all loans in repayment during that year}}$$

Cumulative default rate =

$$\frac{\text{value of loans that have ever defaulted}}{\text{value of loans that have ever been in repayment}}$$

Cohort default rate =

$$\frac{\text{number of borrowers entering repayment who default}}{\text{number of borrowers who enter repayment}}$$

By convention, the first two rates compare the dollar values of defaults and loans in repayment, while the third rate compares the number of borrowers defaulting on loans with the total number of borrowers entering repayment.

A numerical example helps to explain the similarities and differences between these rates. For simplicity, the cohort default rate and the average size of loans are constant over the five years of the example at 15 percent and $2,300, loans are repaid in four years, one-quarter of the loans are repaid at the end of each year, borrowers default only at the end of the first year, and those who default never repay (see Table A-1).

TABLE A-1. A SAMPLE CALCULATION OF THE ANNUAL, CUMULATIVE, AND COHORT DEFAULT RATES

	Year 1	Year 2	Year 3	Year 4	Year 5
Number of Borrowers Entering Repayment Each Year	100	110	120	130	140
Number of Borrowers Entering Repayment Who Default Each Year	15	17	18	20	21
	Loan Values (Thousands of Dollars)				
Value of Loans Entering Repayment Each Year	230	253	276	299	322
Value of New Defaults Each Year	35	39	41	46	48
Value of Loans That Have Ever Defaulted	35	74	115	161	209
Value of Loans That Have Ever Been in Repayment	230	483	759	1,058	1,380
Value of Loans Currently in Repayment	230	399	534	631	683
	Default Rates (Percent)				
Annual	15.2	9.8	7.7	7.3	7.0
Cumulative	15.2	15.3	15.2	15.2	15.1
Cohort	15.0	15.0	15.0	15.0	15.0

SOURCE: Congressional Budget Office.

NOTE: See the text for an explanation of the table.

APPENDIXES

Several definitions are needed to calculate the default rates:

Number of Borrowers Entering Repayment Who Default Each Year	=	Cohort Default Rate	x	Number of Borrowers Entering Repayment Each Year
Value of Loans Entering Repayment Each Year	=	Average Loan	x	Number of Borrowers Entering Repayment Each Year
Value of New Defaults Each Year	=	Average Loan	x	Number of Borrowers Defaulting Each Year
Value of Loans That Have Ever Defaulted	=	Value of New Defaults This Year	+	Value of Loans That Defaulted in the Previous Years of the Program
Value of Loans That Have Ever Been in Repayment	=	Value of Loans That Entered Repayment This Year	+	Value of Loans That Entered Repayment in the Previous Years of the Program
Value of Loans Currently in Repayment	=	Value of Loans That Entered Repayment This Year and the Previous Three Years[1]	_	Value of Defaults in the Previous Three Years
	_	Portion of Loans Entering Repayment in the Previous Three Years That Have Been Paid		

To illustrate these definitions, the calculations for students in the third year are presented (with all dollar amounts rounded to the nearest thousand):

- The number of borrowers defaulting is 18--that is, the 15 percent cohort default rate multiplied by the 120 students entering repayment.

- The value of loans entering repayment is $276,000--the average loan of $2,300 multiplied by the 120 students entering repayment.

1. This is because loans are assumed to be repaid in four years.

- The value of new defaults is $41,400--$2,300 for the 18 students defaulting.

- The value of loans that have ever defaulted is $115,000--$35,000 from the first year plus $39,000 from the second year plus $41,000 from the third year.

- The value of loans that have ever been in repayment is $759,000--$230,000 from the first year plus $253,000 from the second year plus $276,000 from the third year.

- The value of loans currently in repayment is $534,000--$759,000 that have ever been in repayment minus $74,000 in defaults from the previous two years ($35,000 and $39,000) minus $151,000 already repaid from loans made in the first two years and not defaulted (.5 * ($230,000 - $35,000) + .25 * ($253,000 - $39,000)).

The annual default rate and cumulative default rate can be calculated from these intermediate steps. For example, in the third year:

- The annual default rate is 7.7 percent--$41,000 in new defaults divided by $534,000 currently in repayment.

- The cumulative default rate is 15.2 percent--$115,000 that was ever in default divided by $759,000 that has ever been in repayment.

By definition, the annual and cumulative rates are equal in the first year. The annual default rate declines sharply in the first four years as the program becomes established because the value of loans in repayment increases rapidly while the value of new defaults is relatively constant. In the fifth year, the annual rate levels off because the value of loans currently in repayment is relatively fixed (based on the assumption that it takes four years to repay a loan).